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IN THE

Supreme Court of the United States

OCTOBER TERM, 1946.

No. 454

JOSEPH B. FLEMING AND AARON COLNON, TRUSTEES OF THE CHICAGO, ROCK ISLAND AND PACIFIC RAILWAY COMPANY, ET AL.,

Petitioners,

vs.

JOHN C. TRAPHAGEN, JAMES E. GOWEN, GEORGE H. WILSON AND CHARLES G. WOODWARD, CONSTITUTING THE PROTECTIVE COMMITTEE FOR HOLDERS OF CHOCTAW AND MEMPHIS RAILROAD COMPANY FIRST MORTGAGE 5% GOLD BONDS, DUE JANUARY 1, 1949,

Respondents.

REPLY TO RESPONDENTS' BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI.

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Petitioners seek a review by this Court of the judgment below on the ground that there are special and important reasons therefor. It is not merely that $790,000 of trust estate money is involved; it is of grave concern to present and future administration by District Courts and their trustees that the fundamental questions be authoritatively settled. Whether or not the trustees are bound to pay interest coupons at each maturity whenever the mortgage division produces sufficient net income therefor, is a question that materially affects every financial aspect of trus-

tees' administration, *e. g.*, a budget of expenditures for additions and betterments, purchases of needed equipment, rehabilitation program, supply of working capital, etc. If such interest must be paid, obviously the money cannot be used for other purposes however necessary or desirable, whether for the particular mortgage division or the debtor's estate as a whole. It is not a sufficient reply that the interest payment might be deferred with compensation to the bondholders in the form of interest on the delayed interest payment; accumulation of interest on interest simply creates an additional financial burden and problem.

Respondents' claim is founded on the simple fact (as asserted by them) that the C&M mortgage division's earnings exceeded interest requirements. They point to their mortgage division income of $450,882 in 1936 and $399,304 for 1937, "as contrasted with annual interest requirements on the C&M bonds of $176,200." (Brief, p. 5.) Elsewhere they speak of income "in excess of the amounts required for the interest on the bonds during the reorganization proceeding" (p. 2); "earnings available for interest." (pp. 5-11.) Respondents' test of availability is a mere arithmetical excess of mortgage division earnings over interest requirements. They completely ignore that the average annual earnings for 1936 and 1937 of the CO&G estate as a whole were only $259,794, leaving only $83,594 as working capital after a payment of interest. They ignore that the primary obligation of the Trustees is to operate the railroad (*i.e.*, the entire railroad and not merely a mortgage-division) and to give adequate service to the public as a common carrier. They ignore the fact that a Section 77 reorganization proceeding has for its essential purpose a suspension of the rights of creditors pending the preparation and consummation of a plan which shall afford due recognition of those rights.

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Whether there be such an absolute legal duty on the Trustees as claimed by respondents, either to pay interest if earned or to pay compensation if payment be delayed, is a matter upon which the District Courts and their trustees should be informed. No interest upon interest allowance has been made thus far in any plan of reorganization promulgated by the Interstate Commerce Commission, or in any plan confirmed by a District Court.

Respondents assert (Brief, p. 2) that petitioners "have obscured the narrow issue and simulated others". In reality, what we have tried to show is that the issue is not so narrow as respondents make out; that it involves incidences and corollaries. As for the "simulated" issues, we shall show in the succeeding discussion that they are both genuine and germane.

Respondents' Point I.

The opinion of the Circuit Court of Appeals is bottomed squarely on the premise that the bonds of the C&M are no part of the reorganization, in no wise affected by it, and occupy the same position as though there had been no bankruptcy. (R. 246.) All arguments of petitioners and other appellees in the domain of bankruptcy law were rejected. For example, the Court said of their argument that payment of interest on interest was unfair and discriminatory to other creditors that "The fallacy of this reasoning lies in the fact that appellants are not a part of the plan and have no part in the reorganization," etc. (R. 252.)

The inescapable inference from the Court's opinion is that if the C&M bonds did have a part in the reorganization and were a part of the plan, they would be entitled to no interest on interest. Otherwise, the Court was wasting its time in making the distinction.

Now come respondents and say that whether or not the bonds are a part of the plan and of the reorganization proceeding has no bearing upon the right of the bondholders to recover interest on interest. In other words, the Court's ground for allowing interest on interest is no ground at all. The Court engaged in an unnecessary and futile inquiry.

Respondents' position on this point relieves the necessity for further discussion.

Respondents' Point II.

Respondents contend (Brief, p. 8) that if the rights of the C&M bondholders emanate from the plan, as contended by petitioners, then *Prudence Corp.* v. *Geist*, 316 U. S. 89, is applicable. What this Court said in *Prudence Corp.* v. *Geist* was

> "Nothing decided in *Erie R. Co.* v. *Tompkins*, 304 U. S. 64, requires a court of bankruptcy to apply such a local rule governing the liquidation of insolvent estates. The bankruptcy act prescribes its own criteria for distribution to creditors. In the interpretation and application of federal statutes, federal not local law applies."

The applicable "federal" law is the bankruptcy act and the decisions thereunder. That is the law which the Appellate Court should have applied—not the federal law as found in decisions which do not in anywise involve the law of bankruptcy. Yet, it is only non-bankruptcy cases which respondents have assembled as authorities for the proposition that interest coupons draw interest from their dates of maturity. (Brief, p. 9.) We pointed out the non-bankruptcy character of these cases in our previous brief. (p. 25.) Respondents' answer is that petitioners "cannot cite any cases involving bankruptcy proceedings which change the law or which disclose law in favor of

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their contentions." But the burden is upon respondents to establish their case in law as well as in fact. That petitioners are unable to cite a case wherein a bankruptcy court has disallowed (or allowed) interest on interest as a matter of right, indicates merely that no such claim has ever been previously made.

Respondents assume that the law declared in the non-bankruptcy cases carries over without change into bankruptcy proceedings. But it is the very essence of those decisions that they dealt with solvent obligors; solvency, *i.e.*, ability to pay the coupons when due, is the common denominator of them all. Bankruptcy is the haven of the insolvent obligor. Section 77 is denominated a statute "for the relief of debtors." In *Continental Ill. National Bank* v. *CRI&P*, 294 U. S. 648, this Court referred to the fact that the subject of bankruptcy is nothing less than

> "the subject of the relations between an insolvent or non-paying or fraudulent debtor, and his creditors, extending to his and their relief."

What relief is it for the insolvent debtor to be held to the same standard as is the solvent debtor, particularly as respects discharge of the debtor's liabilities accruing during bankruptcy administration? The touch of bankruptcy necessarily changes the color of the legal litmus paper.

Respondents say (Brief, p. 10):

> "The decisions are that bankruptcy does not affect the enforceability of a claim for interest if the assets on which the claim is a first lien are adequate to pay interest."

Since interest itself has been discharged by payment in full, this statement is irrelevant. Equally irrelevant is respondents' stress upon "their perfected lien on earnings". (pp. 2, 11.) As events turned out, the C&M bondholders did not need the benefit of their lien on earnings; the $1,752,000 of accumulated interest was paid to them by order of court as a *pro tanto* consummation of the plan.

Upon such payment, the lien expired. But even while it existed, the lien did not extend to interest on defaulted interest because there was no mortgage contract therefor. Assuming *arguendo* that the lien protected the right to receive payment of the coupons on the due dates, its enforcement was suspended by virtue of the bankruptcy proceeding. The bondholders' right to receive payment on the day was against the debtor, all of whose obligations, including this one, were undergoing the reorganization process. The Sequestration Order specifically provided that nothing therein should be construed "as requiring the Trustees to pay over or earmark" any tolls, earnings, income, etc., pending the further order of the court.

On page 11 of their brief, respondents say that petitioners "assert that by its terms the C&M INDENTURE 'affirmatively' shows * * * that the claim for interest on overdue interest is 'expressly given up.'" The phrase "expressly given up" is nowhere to be found in petitioners' brief. Our assertion is that the lack of intent to require payment of interest on overdue coupons is affirmatively evidenced by the provisions of the mortgage whereby in the event of default giving rise to right of entry into possession by the Mortgage Trustee, the net income is to be applied "to the payment of interest in arrears" (R. 75) and if there be a foreclosure sale, every dollar in excess of principal and simple interest will belong to the mortgagor. (R. 78, 79.)

In response to petitioners' contention that since the C&M mortgage secures only the principal of the bonds and simple interest thereon, interest on interest would constitute at most a general claim in bankruptcy, respondents say (Brief, pp. 11-12):

> "The draftsman of the C&M INDENTURE obviously did not have in mind any situation in which the interest on the C&M Bonds would remain in default for

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almost twelve years despite the fact that earnings of the mortgage property were adequate to pay the interest. It is absurd to impute to the draftsman of the mortgage an intent to give up interest on the overdue coupons in the situation here presented."

We cannot read the mind of the draftsman who prepared the C&M Mortgage and cannot say why he omitted the provision not uncommonly contained in railroad mortgages that interest in default should bear interest until paid. But we do know that the draftsman had in mind the subject of default in interest because he provided specific remedies therefor. See Articles Seventh and Eighth of the Mortgage. (R. p. 74-77.)

Finally, respondents say (Brief, p. 12) that petitioners for the first time seek in their brief to raise the question of whether the earnings of the mortgaged property were adequate to cover the bond interest requirements. Respondents rely solely upon the statement of the Interstate Commerce Commission that

> "The Choctaw & Memphis is a leased line, and the record establishes the fact that its earnings are substantially in excess of its bond interest requirements."

This statement is contained in the Commission's Supplemental Report of July 31, 1941, under the heading, "Petition of the Choctaw committee". (R. 127-130.) As will appear from an examination of the entire text, the subject under discussion is what the plan should provide for the C&M bonds; the various contentions and arguments of the committee are examined and the Commission's conclusions stated. The context in which the above-quoted language appears shows clearly the meaning and purpose of that language:

> "There are outstanding $3,524,000 of Choctaw & Memphis first-mortgage 5-percent bonds with unpaid accrued interest thereon to January 1, 1942, of $1,409,600. The Choctaw & Memphis is a leased line, and

the record establishes the fact that its earnings are substantially in excess of its bond interest requirements. Upon a review of the record we conclude that the lien of these bonds should be preserved and that the Choctaw & Memphis first-mortgage, dated January 2, 1899, amended to extend the maturity date of the bonds to January 1, 1969, and reducing the bond-interest rate to 4% per annum, should be assumed by the reorganized company, and the property conveyed to that company." (R. 128.)

The "record" which established what the C&M mortgage division earnings were, was the formula results for 1936 and 1937; see petitioners' opening brief, pp. 21-22. For its purpose in determining allocations of new securities, the Commission had no occasion to inquire beyond the two test-period years.

But that test period result will not suffice to discharge the burden of proof on respondents. Their own theory requires that the money for paying the coupons was available in the treasury on each maturity date. Proof of such fact has been essential to their claim from the beginning. The Commission's statement is inadequate for the purpose; respondents are unable to point to anything else.

For the reasons stated in the former brief and herein, the petition prayed for should be granted.

Respectfully submitted,

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